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Industrial Distribution

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Philadelphia, PA

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SPECIAL REPORT

Can MOM and POP Survive?

By John G.F. Bonnanzio,
Associate Editor

As mergers and acquisitions reshape industrial distribution, well-capitalized corporations are replacing the family-owned business.

A new kind of entrepreneur is wresting control of the industrial supply business. The old days when father battled the vendors while mom did the books and junior supervised outside sales are vanishing.

Every year more and more family businesses are being acquired by quasi-distributorships, holding companies really, with deep pockets and access to capital. As a result, top management frequently lack traditional industrial supply experience, and are singularly dedicated to streamlining an acquired company's operations.

Observes Gary Buffington, president of the Industrial Distribution Assn., "mergers and acquisitions are creating a more efficient distributor," noting that younger management is quicker to embrace new technologies. While one can argue that this is an industry begging for fresh ideas, others wonder how well a distributorship in Oregon can be managed from Orlando or, for that matter, from Orleans, France.

On the positive side, sons-in-law are less likely to receive as dowries branch operations with questionable profitability. Today, "return on investment" and "shareholder value" are more than just slogans, they are the driving force behind every company with a serious interest in winning market share and turning profits.

Does this mean that family businesses are inherently inadequate when measured against better capitalized companies? "Absolutely not," declares Donald Marshall of Sun Distributors L.P. (see box). Nonetheless, says the industry's leading acquisition maven, "today's mom and pop distributor now faces the same economic considerations that killed the local grocery, hardware, clothing, drug and food store." Specifically, he says, smaller companies simply don't generate enough gross margin to spread across their bottom line.

Of increasing import to distributors (particularly for those who have relied solely on providing credit and inventory turns for profits), are economies of scale. While limited purchasing power can be a disadvan-

Sun Distributor's Donald T. Marshall: How many distributors can $100 million buy?

tage to smaller companies, it is not an all-important factor. However, sharing front-end expenses such as computers, software design, bar coding, EDI, material handling and telecommunications costs have made distribution a far more capital intensive business.

Says merger and acquisition consultant George Spilka, "The $3- to $4 million distributor is no longer large enough to amortize its entire functional support area. The mom and pop can effectively compete without such things as data processing," he says, "but only by providing personalized services to its customers."

Even at the nation's largest industrial distributorship, W.W. Grainger, Inc., that fact is not lost on the company's CEO Wiley Caldwell. "Depending on the complexity of the business," he says, "economies of scale can be important." Which is why the $1.6 billion distributorship has invested heavily in data and information processing systems. At the same time, Grainger's acquisition of Vonnegut Industrial Products, Inc. (a $40 million cutting tools and abrasives house), demonstrates Caldwell's appreciation of large, specialized distributorships, with regional strength and expansive technical expertise—two capabilities more easily acquired than developed.

CHANGING ISN'T EASY

In its 1987 report *Facing the Forces of Change*, Arthur Andersen & Co. concluded that only those companies willing to make "fundamental changes" to their current business

The friendly acquirer

From the 26th floor of his company's Philadelphia headquarters, Donald Marshall looks out over a land full of opportunity. As Marshall sees it, simple demographics is a prime contributor to Sun Distributors' rapid expansion. Why?

For the thousands of distributors who started their businesses shortly after the Second World War, their retirement years have arrived. Many don't have family members to take the helm. Others see the industry consolidating, changing, getting more complicated—less profitable—and simply want out. "Maybe they start feeling a few heart twinges," says Marshall, "and the wife says 'why not enjoy the years we have left in Florida?'

That's when telephones on the 26th floor begin to ring. And ring they do. Marshall says that every year hundreds of distributors approach Sun with the intention of being acquired. For the most part, they are companies in the fluid power, electrical, maintenance (fasteners) and glass business—Sun's four areas of specialization.

Why all of the interest in Sun? First, the publicly-held distributor has a reputation as a friendly acquirer. But, more importantly, its hands-off management style is comfortable to people who have never had bosses. And with a mere 13 employees to oversee sales that should easily surpass $600 million this year, Sun's corporate culture is decidedly more lean than mean.

"We really want the companies we buy to run themselves," says the 56-year-old Marshall, and he won't even consider an acquisition unless the seller stays with the business for three years. "Distribution is still a people business," he says, noting that it's the company's management team that makes the difference. "If you're well financed, any fool can buy the inventory and put an organization together. But it takes a special skill to sell it, and to make money on it."

Marshall has that special skill. While Sun has never paid a dividend on its B, or common shares since going public in 1987 (Class A stock has), much of that is due to non-recurring expenses. For one thing, Sun Distributors was acquired through a leveraged buyout from the Sun Oil Co. in 1986. In 1987 the newborn company lost $6.6 million, earned $12 million in 1988, and made $13.2 million during the first nine months of 1989. In addition, sales have increased for eight straight quarters, and Marshall expects to add $75- to $100 million in sales over the next two years through acquisitions.

To fund these buy-outs, Marshall will continue to spend accumulated cash. Marshall's mission includes buying as many of the nation's premium, value-added distributors as the company can find and afford. Since 1987, 30 such businesses have been bought. "This window of opportunity won't last forever," he says, "and if we don't get them now, someone else will."

Don Struble has been doing the same thing for 28 years, and now thanks to Sun, he's finally getting out. For 17 of those years Struble, 52, has owned and managed Denver's Warren Fluid Power Co., and has presumably made it profitable. In the process, he has also made his company an attractive addition to Sun's stable of 4 other fluid power businesses.

WARREN
FLUID POWER

"The thing I like about Sun is that they allow you to operate autonomously," says Struble. In fact, since the company was purchased in 1987, Struble has been to the company's headquarters but once, and that was to close the deal. "They feel that the economies of scale in purchasing aren't worth sacrificing a company's independence," says Struble, and in fact, Sun's four group vice presidents never, ever meet with a company's customers.

However, Sun does provide Struble with managerial "guidance." "They're a good resource," he says, "and they have plenty of capital for expansion." And that expansion will no doubt continue long after Struble completes his three year obligation to Sun this July when he officially steps away from Warren. And what will he do with his newly found freedom? "I haven't had time to think about it," Struble says, "I've been too busy growing the business."

practices will survive this current period of "aggressive restructuring (see *ID* Aug. '87)." Nearly three years after that study's release, many of its prognostications have already come to fruition. Says the firm's Patrick Dolan, "Mergers and acquisitions will continue. The big will get bigger, the small will niche and the medium will try various strategies in order to survive and prosper."

The Arthur Andersen report, which was conducted for the National Assn. of Wholesaler-Distributors (NAW), examined four major areas of distribution. These so-called "forces," which were categorized as market, financial, organizational and technological, are worth re-examining because each so dramatically impacts the industry's merger and acquisition climate. In addition, the study has proved itself remarkably accurate in sketching future trends in wholesale-distribution.

THE BIG GET BIGGER

Arthur Andersen predicted that the number of merchant wholesale distribution firms would decline by approximately 25% between 1987 and 1995. The question is whether this number would hold true for industrial suppliers as well. Although there is no data to indicate if this has occured, data does corroborate that merger and acquisition activity is widely prevalent in the industry.

As *ID* reported in its July 1989 issue, 25% of distributors with $5 million or more in sales are "actively" seeking an acquisition, compared to 12% of distributors with sales between $2.1- and $5 million; 10% with sales between $1- and $2 million and; 10% with sales below $1 million. Conversely, 36% of those with less than $1 million in sales said they would "welcome" an acquisition offer, while 23% in the $5 million-plus range thought favorably about being acquired.

But even in today's marketplace a $5 million distributorship can hardly be considered a heavyweight, not when hundred-million dollar businesses are increasingly common. While *ID*'s Survey found that in 1988 the average distributor had sales of $5.2 million, half of the industry still reports revenues of $2.1 million or less. What this means is a golden opportunity for large distributors with young, aggressive management to acquire smaller, family-run distributorships with founders reaching retirement age. However, not all large distributorships look favorably upon this kind of acquisition.

"We've really made it a strategy to stay away from the smaller distributor," says Briggs-Weaver's CEO Rob Mellor. In one instance, rather than acquire a distributor in El Paso, an area where the Dallas-based company wanted to expand, Mellor decided instead to "work hard for new customers" and took the slower approach of opening a new branch. I know a half dozen distributors that if you gave them the right size check, you could walk away with their business."

Technology requires access to capital.

This is hardly news to Mitchell Jacobson, whose Long Island company has been gobbling-up "smallish" distributorships like potato chips. "Size can provide some real advantages," he says, and has set out to prove it by engaging in an expensive acquisition spree.

In the past few years Jacobson, as president of MSC Industrial Supply, Inc., has extended the company's reach from New York to include branches in New Jersey, Connecticut, Massachusetts, Rhode Island, Pennsylvania, Texas, Louisiana, Colorado and Nebraska. Although vague with company financials, Jacobson says that MSC now sports about 20 branches with sales totaling $100 million. Meaning, that despite its overall size, each branch averages only the typical $5 million in revenues.

So what's the advantage? "The more product you move the lower your costs," says Jacobson, adding that larger distributorships can also leverage the expenses of information services, inventory, catalog costs, and management/personnel costs. Which is not to suggest that Jacobson feels comfortable with the size of his present operation.

"The distribution landscape is changing radically," he says, and predicts that even the $200 million distributor will find the market a "struggle" to survive in just five years from now. By then, a $500 million distributor will be a "stable player," he predicts, and at $1 billion "a market leader." So what then is MSC's strategy for the future? "Obviously," says Jacobson, "you can expect to see us making more acquisitions."

TECHNOLOGY DRIVES ECONOMY

On the technology side of distribution, Arthur Andersen makes a convincing argument that there is an increasing need to improve distributor productivity. This is both expensive and an imperative in order to remain a competitive supplier of products. "EDP costs as a percent of sales will almost double by 1995 from 1.6% to 3%...and expenditures for scanning equipment, telemarketing and vendor/customer links will also increase significantly," says the report. "Improved working capital management...will allow wholesaler-distributors to invest more of total assets in fixed assets, which will allow firms to improve productivity."

According to *ID* 's Survey, not only are larger suppliers more computerized, but their total electronic data processing (EDP) costs appear proportionately higher as well. And these expenses are rising (see chart above). In 1987 distributors spent an average of $67,000 on EDP.

WHAT SMALL DISTRIBUTORS CAN'T DO*

	% with computers	% using EDI	% using systems Contract Sales	Total EDP costs ($ thousands)
Distributor sales size				
Less than $1 million	38	9	15	7
$1-2 million	67	12	33	21
$2.1-5 million	81	30	37	23
More than $5 million	99	58	55	79

*All data for 1988

Source: ID's Survey of Distributor Operations

CIRCLE NO. 18 ►

By 1988 that figure climbed to $71,000, a 6% increase. This was due, says the report, to rising salary and equipment costs while material and software costs declined slightly.

The Survey also demonstrates that smaller, less computerized distributors are forfeiting the opportunity to offer customers such important selling arrangements as systems contracts and electronic data interchange (EDI). Without these services, a distributorship's ability to increase inventory turns while marketing itself as a low-cost vendor is a decidedly more difficult task.

This means that in order to grow, investments must be made in expensive technologies, even at the expense of short-term earnings. But the Arthur Andersen report does not believe that future capital needs can be fully met by retained earnings alone. For larger distributors this is probably true. However, smaller supply houses will continue their reliance on commercial leaders, or of course, find well-heeled suitors.

At Alamo Iron Works, Carl Schenken, Jr, who recently relinquished his presidency to an investor group, does not dismiss the possibility that larger companies will turn to public capital markets to finance growth. "It's an interesting concept," says Schenken, although he's quick to recognize that there are not very many publicly held industrial distributorships. "This is a very capital intensive business, and public capital has not been widely used."

Potentially, says Schenken, this may mean an opportunity for the right company. "If you can provide a competitive return on equity to the brokerage houses and institutions; if you can offer stability in a unique situation—you have a niche. And that appeals to a lot of investors." Schenken also believes the "next generation" of distributors, "call it the mega-distributor," will have advantages in terms of purchasing power, but will find difficulties in servicing local customers.

"The small distributor is certainly more fleet-a-foot; and so there will always be opportunities for them," he says. However, Schenken also spies some opportunities for the larger supply house. "My concept is the larger distributor can turn that advantage around, and use its size to develop speed."

In the Texas market where Alamo operates a variety of businesses, Schenken suggests a shake-out in

NOTABLE MERGERS & ACQUISITIONS OF 1988/89

Purchaser	Acquired
Cutting Tools & Abrasives	
Kennametal, Inc. Pittsburgh, PA	Garrett Industrial Supply Co. of Allied Signal Aerospace Phoenix, AZ
	J & L Industrial Supply, Detroit, MI
Manufacturers Supply Grand Rapids, MI	Lakeshore Machinery & Supply, Muskegon, MI
General Industrial	
Boring & Smith Tucker, GA	Dixie Industrial Supply, Lexington, KY, and Shelby, NC
ENSCO, Tucker, GA	
Briggs-Weaver Dallas	Merges with Texas Marine & Industrial Supply Houston, TX Both companies are owned by Sammons Enterprises of Dallas
	Equipment Supply Co., Mobile, AL
Cardinal Industries Vernon, CT	Brian Supply Co., Providence, RI
	Lindquist Supply, Bridgeport, CT
	Syracuse Supply/Industrial Products Div., Syracuse, NY
Dillon Supply Co. Raleigh, NC	Industrial Tools & Abrasives, Inc., Madison, AL
MSC Industrial Supply Plainview, NY	Dancorp, Danvers, MA
The Summers Group Dallas, TX	Weaks Supply Co., Shreveport, LA
W.W. Grainger Elmhurst, IL	Vonnegut Industrial Supply Co., Indianapolis, IN
	Mansco-Lakeshore, Inc., Grand Rapids and Muskegon, MI
The Geo. Worthington Co. Mentor, OH	Erie Industrial Supply, Erie, PA
Fluid Power	
Harris Pump & Supply Co. Pittsburgh, PA	C.A. Turner, Inc., Pittsburgh, PA
	Pittsburgh branch, Pa. & W. Va. Supply Co., Columbus, OH
Pa. & W. Va. Supply Co. Columbus, OH	Certain assets of Al Supply Co., Shrewsbury, WV
Sun Distribution Philadelphia, PA	A. & H. Bolt & Nut, Windsor, Ont
Machine Tools	
Fuchs Machinery Co. Omaha, NE	Machine Tool Div. of Applied Machine Systems, Denver, CO
Geo. Worthington Co. Mentor, OH	Erie Industrial Supply, Erie, PA
Materials Handling	
Modern Group Ltd., a holding subsidiary of Modern Handling Equipment Co., Bristol, PA	Elfenstone, Baltimore, MD RZ, Bristol, PA
Power Transmission	
Shingle & Gibb Co. Pennsauken, NJ	Slaysman Drives & Controls, Baltimore, MD Zwiebel Drives & Controls, Wilkes Barre, PA
Industrial Rubber & Hose	
G.T. Sales & Manufacturing Wichita, KS	Ranger Rubber Co., Omaha, NB
Specialty Tools & Fasteners	
Carlson Systems Omaha, NE	Strapco, Portland, OR, Tacoma, WA
Fastener Services, Inc., A Detroit-based management company	Florida Nut & Bolt, West Palm Beach, Ft. Lauderdale Materials Management Group, Appleton, WI

This information is a partial listing, and is as accurate as can be determined from various sources at the time of publication.

the oil patch is almost inevitable. Some of the state's already large players are going to wind-up even larger, he says. It's no secret that Briggs-Weaver was seriously courting Garret Industrial Supply before the California distributor was bought by Kennametal Inc., a match-up that Briggs-Weaver's Rob Mellor says would have been "perfect synergy."

Other contenders for the Texas market must certainly include Houston's Rex Supply Group, MSC Industrial (with its acquisition of Service Tool's four state-wide branches), and perhaps even W.W. Grainger, when (and if) it diverts its attention away from the mid-west. Says Schenken, "It's very easy to see who's sitting around the poker table. It's just a question of who's going to walk away with all the winnings."

Who's holding all the cards in Texas? B-W's Rob Mellor should be watched.

BANDING TOGETHER FOR PROFITS

While no one, or even 100 distributors are likely to dominate the entire industrial supply business in years ahead, the industry is already fashioning itself after its close cousin, the hardware store. While local shops still exist in every small town and metropolis, most independent hardware stores are members of buying/marketing groups such as Sentry, True Value and Ace Hardware. Although these relationships bring purchasing power and shared promotional costs to the hardware store, the value-added service of local convenience remains their greatest strength.

Similarly, small industrial distributors can operate the same way, but not if a competitor such as W.W. Grainger operates nearby. Which is why buying/marketing groups like ID One on the industrial side, and Evergreen on the construction side, are increasingly popular. If the independent mom and pop supplier cannot compete on price (which it can't), all that remains is service and technical expertise. And technical expertise, such as hiring an engineer, does not come cheap.

"Ten years ago industrial distribution was one of the last places in America where an entrepreneur could buy a little inventory and set himself up in business," says Sun's Donald Marshall. And although he believes small independents can carve out niches, their ability to add value to products without sharing costs places these distributors in a very precarious position. "It's sad but it's true," he says, "But S.O.B.s like me, are taking it all over." □

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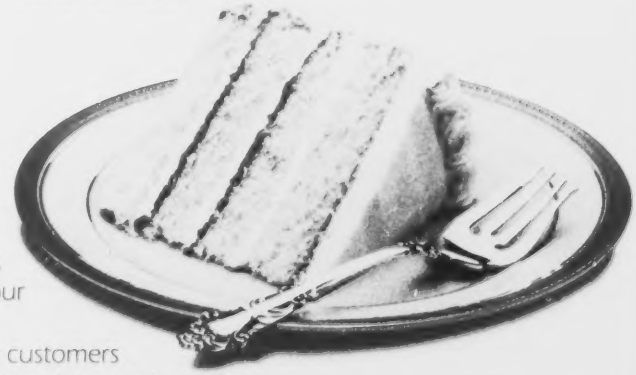

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BUSINESS REPORT

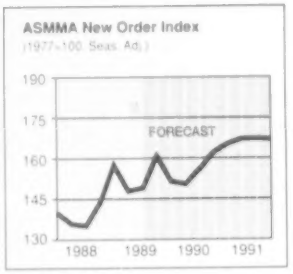
BY KRIS BLEDOWSKI

Mixed economic outlook for '90

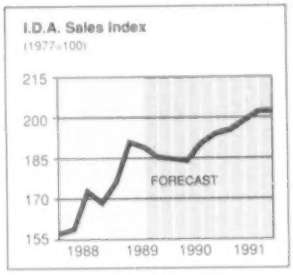
Fluid power slows while materials handling expands

An 8.5% miniboom in the fluid power industry during 1989 will definitely not be repeated in 1990. Exports are declining sharply, and demand by domestic consumers will not be able to sustain last year's expansion. Expect growth to slow to 1.8% by year-end 1990.

Pneumatics will show the strongest growth, with an expected gain of 6.2% in 1990. Industrial hydraulics have benefitted from an expansion in capacity which many firms have undertaken recently. This industry is expected to register a gain of 4.2%. Mobile hydraulics, the largest portion of the industry, has seen weak growth and will continue to grow at this pace throughout next year. The forecast calls for an increase of just 1.8%.



Data source: ASMMA
Forecast source: Cahners Economics



Data source: I.D.A.
Forecast source: Cahners Economics

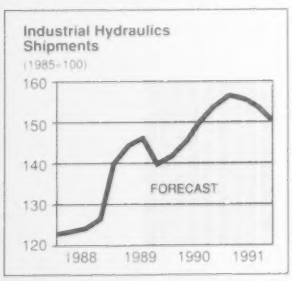
Orders for materials handling equipment weakened in the last months of last year. This contrasts sharply with comparably strong previous-year levels. Buyers have been cautious to spend on new durable equipment when operations volumes may sag in 1990. These conservative spending patterns will continue into the early part of 1990.

As the economy gains momentum, forklift truck orders will gain about 7% this coming year, up from a decline of 2% in 1989. Leadtimes will remain in the nine week range through most of 1990 before stretching out a bit in 1991.

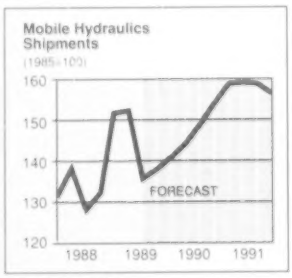
Conveyor orders softened last year but were still above levels of a year before and this trend will continue in 1990. This year's forecast calls for a 2.5% gain followed by a more pronounced expansion in 1991.

Orders for caster and floor trucks will grow much more robustly in both 1990 and 1991. Expect gains of 8.5% and 10.5%, respectively.

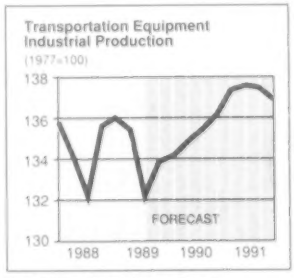
The auto industry achieved record profits and sales in 1988. Output of motor vehicles and parts rose 5.1% in real terms, while domestically produced cars alone were up 6.5%. By comparison, this past year was flat, with no growth in industrial production of transportation equipment in general, and a drop of about 3% in auto sales in particular. The transportation industry, which also includes aircraft, ships, railroad equipment, and space gear, will post an increase of 0.5% in output in 1990. □



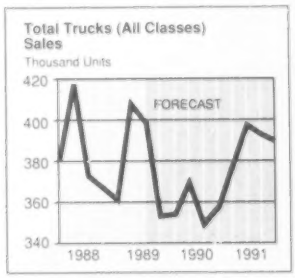
Data source: NFPA
Forecast source: Cahners Economics



Data source: NFPA
Forecast source: Cahners Economics



Data source: Federal Reserve Board
Forecast source: Cahners Economics



Data source: MVMA
Forecast source: Cahners Economics

(1977=100)	SALES Nov. 1989	SALES Oct. 1989	SALES Nov. '89 vs Nov. '88 % change	RECEIVABLES Nov. 1989 days	INVENTORY Nov. 1989 % change
TOTAL	189.8	175.0	13.9	43.3	-0.8
EAST	154.3	157.7	4.6	48.1	-2.0
SOUTH	243.6	248.3	11.8	46.4	-2.1
CENTRAL	174.6	141.8	23.9	41.0	-0.1
WEST	191.3	189.8	-3.2	35.6	+0.8

SOURCE: Industrial Distribution Assn.

SUPPLY OUTLOOK

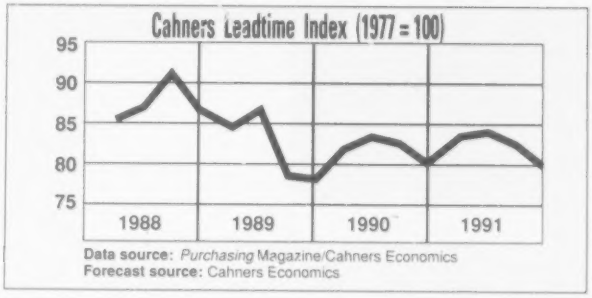
BY PAUL WATERS

Prices and leadtimes fall

Business activity to pick up in mid-1990

Producer prices (PPI) on finished goods are softening. Both the National Assn. of Purchasing Managers (NAPM) and *Purchasing* Magazine's surveys on prices show more buyers reporting falling prices now than in the last two years.

For example, the PPI for the 2nd quarter of 1989 was up 5.9% over the same period 1988. For the fourth quarter of 1989, however, prices are expected to climb only 4.2% from the previous year's levels. Similarly, inflation for fabricated metal products was 8.6% in 1988. In 1989 it was 4.9%, while in 1990 we predict it to be only 2.5%.



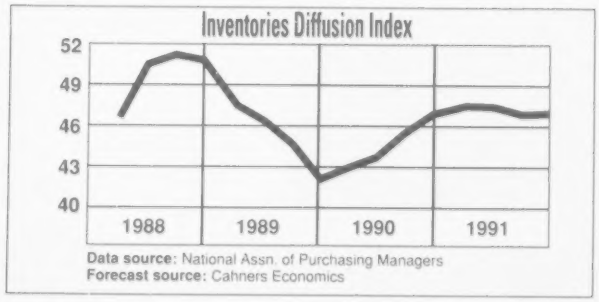
Inflation for intermediate materials is heading down even faster. For the first three months of 1989, prices for these goods were up 6.3% over the same period in 1988. In contrast, prices during the last three months of 1989 will be only 2.9% above last quarter 1988 levels. Furthermore, we project prices on all intermediate materials to creep up only 1.6% in 1990.

Inventories continue to decrease slowly. In a recent survey of purchasing managers, 38% reported decreasing inventories and 40% said inventories were holding steady. Only 22% claimed that inventories were increasing during this economic slowdown, a tribute to modern inventory control.

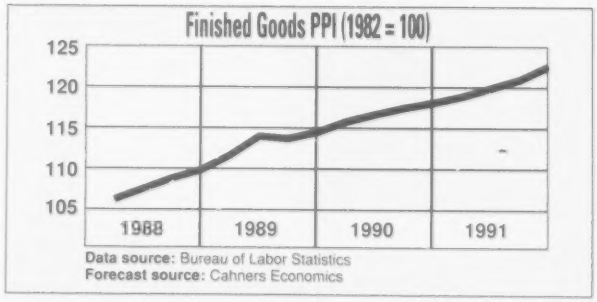
The economic slowdown is shortening delivery times on most goods. The Cahners Lead-time Index will finish 1989 nearly 7.0% below 1988 levels. The index is not forecasted to change for 1990, a sign of stable leadtimes as the economy slowly rebounds.

Last November, the NAPM vendor deliveries index dropped for the seventh consecutive month, highlighting recent weak demand.

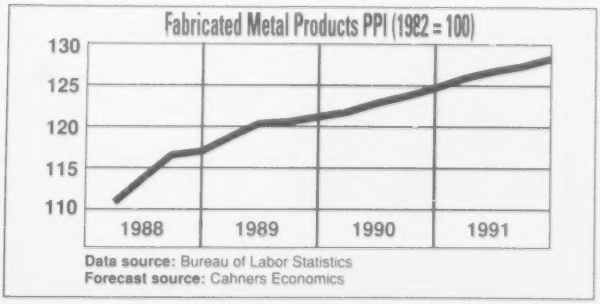
The NAPM indices of economic activity, new orders, and production will inch above the critical 50% mark in the third quarter. The second half of the year will be strong, but easy availability of goods will help keep prices low.



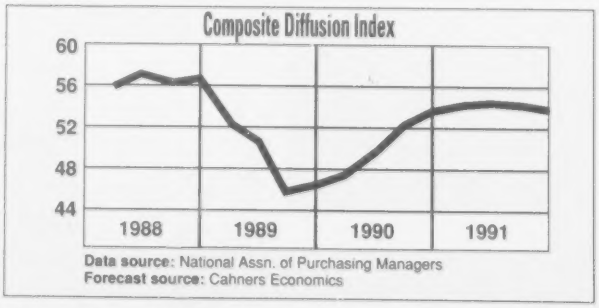
Expect inventories to continue falling slowly through 1990, picking up at mid-year.



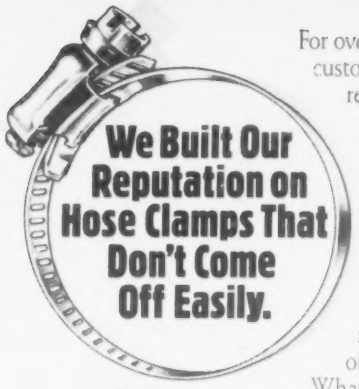
Producer prices for finished goods will rise only 3.1% in 1990 thanks to the slow economy.



After high inflation in 1988 and 1989, prices for fabricated metal goods will creep up only 2.5% in 1990.



The economy will pick up in the 3rd quarter, indicated by an expected index value of 52.2.



For over 65 years our customers have come to rely on Tridon hose clamps for durability. Because all Tridon Inc. hose clamps are 100% U.S. made, using corrosion-resistant 300 grade stainless steel. And corrosion is the primary cause of clamp failure.

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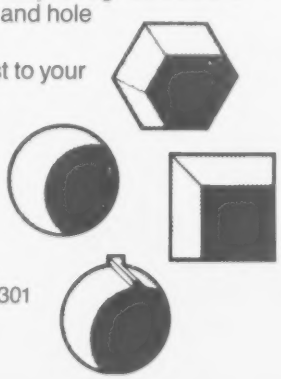

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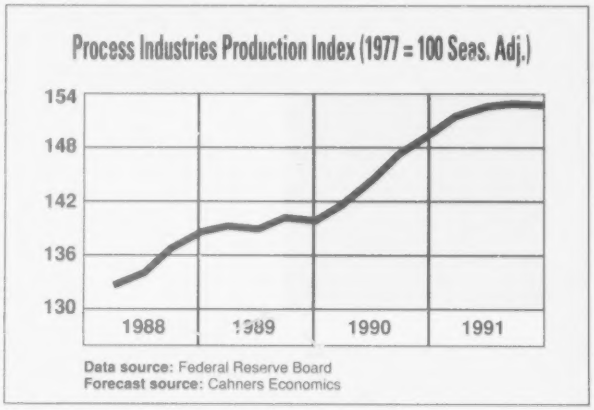
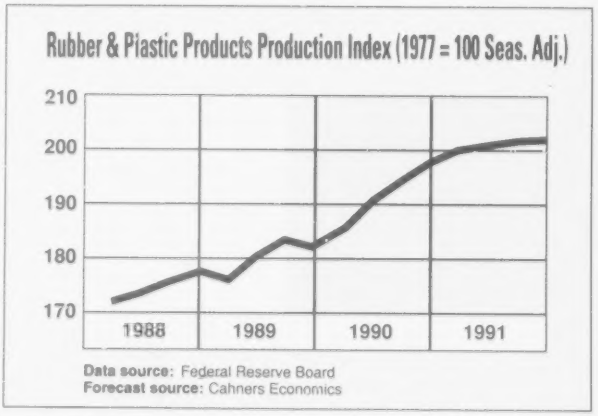
SUPPLY OUTLOOK

Process industries outpace others in 1990

Process industries will be one of the strongest industrial sectors in 1990, with 4.3% growth forecasted. In contrast, overall manufacturing production will be up by only 2.8% this year. Plastics will lead the process industries with an expected 6.4% surge in output, as consumer packaging and construction applications revive. Chemicals will follow with an estimated 5.1% production gain as exports and manufacturing demand remain solid. Production of paper products will also be strong, logging in at a projected 3.8% growth. An increase of 3.4% in coated free sheet shipments will help lead the way.



Production in the process industries will be up over 4.3% in 1990 and 1991, lead by plastics and chemicals.



Output of plastic products will jump up 6.4% this year and 4.7% in 1991.

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